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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

VIA HAND DELIVERY

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
Room TW-325
445 Twelfth Street, SW
Washington, DC 20554

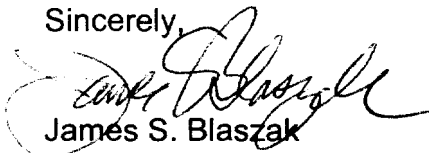
Re: Ex parte contact in CC Docket Nos. 94-1 and 96-262

Dear Ms Salas:

On February 7, 2000, Lee L. Selwyn and Patricia D. Kravtin of Economics and Technology, Inc. and the undersigned, on behalf of the Ad Hoc Telecommunications Users Committee, met with representatives of the Common Carrier Bureau, Chairman Kennard's office and the offices of Commissioners Ness, and Tristani. The substance of those conversations is reflected in the attachments to this letter.

In accordance with Section 1.1206(b)(2) of the Commission's Rules, 47 C.F.R. § 1.1206(b)(1) and (2), two copies of this letter along with its attachments and a diskette containing this letter formatted in Microsoft Word are included herein regarding the above-captioned proceeding.

Sincerely,



James S. Blaszak

Counsel to the Ad Hoc
Telecommunications Users Committee

Attachments

cc: Sarah Whitesell (w/o attachments)
Jordan Goldstein (w/o attachments)
Richard Lerner (w/o attachments)
Dorothy Atwood (w/o attachments)

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***Ad Hoc Telecommunications
Users Committee***

**The X-Factor Should Be Increased
To Produce The Competitive Result.**

- A. The goal of price caps regulation: Produce the competitive result.
 - 1. In competitive markets, “creamy returns” are transitory.
 - 2. Periodic adjustments to the X-Factor:
 - i. Induce carriers to improve productivity.
 - ii. Do not violate any so-called “contract” with the LECs.
- B. The Commission should use an adjusted TFP methodology to set the X-Factor.
 - 1. Staff’s 1999 TFP study is a good starting point
 - 2. Minor data adjustments are warranted.
 - 3. An interstate X-factor can and should be prescribed.
 - i. Prior Commission position: Problem determining interstate inputs
 - ii. AT&T has shown that jurisdictional input differences are immaterial.
 - iii. USTA’s expert’s unexplained and inconsistent position on interstate X-Factor.
 - iv. Allocating factors of production among jurisdictions is no more arbitrary than allocating joint and common costs among jurisdictions and among tariffed and unregulated services.
 - v. Failure to prescribe an interstate X-Factor will understate the ILECs’ interstate TFP rate.
 - 4. Other TFP Study adjustments:
 - i. Cost of capital index
 - ii. Measure of local output
 - iii. Severance buyouts
 - 5. The Commission should retain a Consumer Productivity Dividend (CPD) of 0.95%.
- C. The Commission should prescribe an interstate X-factor of approximately 10%.

Price Cap X-Factor Prescription CC Dkt. Nos. 94-1/ 96-262

Ad Hoc Telecommunications Users
Committee

February 7, 2000

Threshold Question

Which of the three options identified in the Commission's Notice should be relied upon in estimating the X-factor?

- *Option 1 (1997 Staff TFP Study)*: USTA/LECs support this option, subject to specified updates.
- *Option 2 (1999 Staff TFP study)*: Non-LEC parties (Ad Hoc, AT&T, MCI, Missouri Public Service Commission) support this option, subject to identified refinements.
- *Option 3 (Imputed Study)*: GSA supports this option as its primary recommendation. Other parties (Ad Hoc, MCI, AT&T) also support either as viable option or important corroborative evidence of higher interstate productivity.

Threshold Question (continued)

**Which of the three options identified in the Commission's Notice should be relied upon in estimating the X-factor?
(continued)**

- *Other Options Identified by the Parties:*
 - AT&T also recommends using “*Direct Method*” whereby interstate-only X-factor is calculated on the basis of output and revenue growth (input terms cancel out of X-factor formula).
 - USTA also recommends using previously submitted *USTA TFPRP* (as updated) for calculating X-factor on a going-forward basis.

Threshold Answers

- The Commission should continue to rely on Total Factor Productivity Studies in calculating the historic component of the X-factor:
- Subject to a few refinements, the 1999 Staff Study provides a method of calculating LEC productivity that is both theoretically and empirically sound.
- Given identified methodological defects and staleness of data, the 1997 Study should not be relied on in setting the X-factor either for the remand period or on a going-forward basis, nor should USTA's TFPRP be relied on.
- The Imputed X Study provides corroborative evidence of increasing interstate productivity.

Threshold Answers (continued)

- The Commission has the tools available to calculate an interstate-only X-Factor, and therefore it must.
- Previously-expressed concerns regarding the inability to allocate common inputs in a TFP study are shown to be irrelevant in the AT&T analysis.
- AT&T's analysis also provides additional rationale for applying an assumption of uniform input growth in a TFP study.
- The Imputed Study offers an alternative method of calculating an interstate-only TFP.

Threshold Answers (continued)

- A CPD is warranted and defensible methods of quantifying the CPD have been identified.
 - Relationships between relative efficiency incentives under rate or return vis-a-vis price caps with sharing, and under price caps with sharing vis-a-vis price caps without sharing identified in the SPR Study previously sponsored by the price cap LECs provide a basis for estimating potential efficiency gains associated with the elimination of sharing.
 - The measurable effect on LEC productivity associated with the original adoption of price caps also provides a conservative approximation of potential efficiency gains associated with the elimination of sharing.

Refinements to the 1999 Staff TFP Study

| (a) Description | (b) Positions of Parties | (c) Impact on TFP Results | (d) AD Hoc Recommendation |
|---|--|---|--|
| 1 Correction of minor data errors, i.e, formulaic errors, updated ARMIS/SOCC, exclusion of SNET, publicly available BLS data. | Little disagreement. | Little measurable impact. | Make corrections based on publicly available data. |
| 2 Adjustment to cost of capital index to reflect competitive cost of capital. | Little consensus among proposed methodologies. | Of all proposed adjustments, has greatest impact (est. 2%). | Revise Staff methodology to reflect synthesis of AT&T/MCI refinements. |
| 3 Measure of local output. | USTA/LECs propose access lines, other parties adopt Staff's use of local DEMS. | Moderate impact (est. 1%). | Adopt Staff's use of local DEMS. |
| 4 Adjustment to labor expense for unusually high levels of severance buyouts. | USTA/LECs oppose, Ad Hoc, MCI, AT&T support. | Small Impact on TFP results (est. 0.05% -0.066%) | Adopt Staff adjustment. |

Various TFP Models That Can Be Relied on to Estimate the X-Factor

| | General Methodology |
|----------------------|--|
| Staff | 1999 Staff TFP Study |
| Ad Hoc | 1999 Staff TFP Study corrected for data errors |
| MCI | 1999 Staff TFP Study corrected for data errors and refined cost of capital adjustment |
| AT&T (1) | AT&T Direct Method |
| AT&T (2) | AT&T Direct Method |
| AT&T (3) | 1999 Staff TFP Study corrected for data errors and refined cost of capital adjustment |
| Synthesis (1) | 1999 Staff TFP Study corrected for data errors and cost of capital adjustment based on AT&T's methodology, but MCI's rate of return series |
| Synthesis (2) | AT&T Direct Method w/ cost of capital adjustment based on AT&T methodology but MCI's rate of return series |
| USTA (1) | Updated 1997 Staff TFP Study |
| USTA (2) | Updated TFP Review Plan (TFPRP) |

Summary of Various TFP Model Differences

| | (a) |
|----------------------|---|
| | Development of Competitive Cost of Capital (COC) Index |
| Staff | Applies change in Moody's Baa series to base year 1991 imputed COC, where imputed COC is a measure of capital rental price defined as LEC property income (PI) divided by capital stock (CS). |
| Ad Hoc | Adopts Staff methodology. |
| MCI | Applies Moody's Baa series to only the equity (E) portion of base year 1991 11.25% ROR. New E series is combined with debt (D) costs per ARMIS using D/E ratios per ARMIS to develop a competitive ROR series which is then used to adjust LEC PI less depreciation (DEP) to competitive level. DEP is added back to the adjusted PI series, and resulting total PI divided by LEC CS produces revised imputed COC. |
| AT&T (1) | Develops competitive ROR series by applying a trend line between Commission's approved 11.25% ROR and AT&T's recommended 8.63%, and uses the ROR series to adjust LEC revenue growth to reflect tax-adjusted competitive earnings. |
| AT&T (2) | Same as AT&T (1), except competitive ROR is derived by applying Moody's Baa series to the base year 1991 11.25% ROR. |
| AT&T (3) | Applies Moody's Baa series to base year 1991 11.25% ROR (versus imputed COC) and uses ROR series to adjust LEC PI to reflect tax-adjusted competitive earnings. New PI series divided by CS produces revised imputed COC. |
| Synthesis (1) | Same as AT&T (3), except applies MCI's competitive rate of return series. |
| Synthesis (2) | Same as AT&T (1), except applies MCI's competitive rate of return series. |
| USTA (1) | Does not develop competitive COC, uses unadjusted internal ROR. |
| USTA (2) | Uses external COC based on aggregate U.S. National Income Accounts. |

Summary of Various TFP Model Differences (continued)

| | (b) Measure of Local Output | (c) Adjustment to Labor Expense for Excess Benefits |
|----------------------|------------------------------------|--|
| Staff | Uses local DEMs. | Removes excess severance payouts (i.e., benefits in excess of historical trend). |
| Ad Hoc | Adopts Staff's use of local DEMs. | Adopts Staff's adjustment. |
| MCI | Adopts Staff's use of local DEMs. | Adopts Staff's adjustment. |
| AT&T (1) | Adopts Staff's use of local DEMs | No need to apply adjustment, since inputs drop out of formula. |
| AT&T (2) | Adopts Staff's use of local DEMs. | Adopts Staff's adjustment. |
| AT&T (3) | Adopts Staff's use of local DEMs. | Adopts Staff's adjustment. |
| Synthesis (1) | Adopts Staff's use of local DEMs. | Adopts Staff's adjustment. |
| Synthesis (2) | Adopts Staff's use of local DEMs. | No need to apply adjustment, since inputs drop out of formula. |
| USTA (1) | Uses access lines. | Makes no adjustment. |
| USTA (2) | Uses deflated revenues. | Makes no adjustment. |

**Summary of Total Company X-Factors
(Excluding the Consumer Productivity Dividend)
Derived from Various Models**

| | 1991-1995 | 1991-1998 |
|-------------|-----------|-----------|
| STAFF | 6.14% | 6.33% |
| AD HOC | 5.97% | 6.75% |
| MCI | 5.66% | 6.12% |
| AT&T 1 | 6.54% | 6.88% |
| AT&T 2 | 6.59% | 6.86% |
| AT&T 3 | 6.66% | 6.86% |
| SYNTHESIS 1 | 6.84% | 6.89% |
| SYNTHESIS 2 | 6.77% | 6.89% |
| USTA 1 | 5.00% | 4.12% |
| USTA 2 | 2.36% | 3.19% |

**Summary of Interstate Only X-Factors
(Excluding the Consumer Productivity Dividend)
Derived from Various Models**

| | 1991-1995 | 1991-1998 |
|-------------|-----------|-----------|
| STAFF | N/A | N/A |
| AD HOC | 10.31% | 9.95% |
| MCI | 10.00% | 9.48% |
| AT&T 1 | 10.33% | 9.14% |
| AT&T 2 | 10.63% | 9.73% |
| AT&T 3 | 11.06% | 10.02% |
| SYNTHESIS 1 | 11.24% | 10.05% |
| SYNTHESIS 2 | 10.57% | 9.16% |
| USTA 1 | N/A | N/A |
| USTA 2 | N/A | N/A |

Summary of Proposed Consumer Productivity Dividend

| | CPD |
|-----------------|------------|
| AD HOC | 0.95% |
| AT&T | 1.00% |
| USTA | 0.00% |